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Administrative Proceeding against Rajat Gupta Marks a Turning Point in SEC Enforcement Actions

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Every once in a while we look back at a point in time and say "that was a turning point." The Securities and Exchange Commission's (SEC) recent administrative action seeking a cease and desist order against Rajat Gupta will likely prove to be just such an event. It will mark the era when the SEC moved away from steadfastly seeking injunctive actions in federal district court and started thinking more expansively about what it really wants to achieve by bringing an enforcement action. While it is unlikely that the SEC will start bringing only administrative proceedings and abandon federal district court, there is also no doubt that the Gupta action demonstrates that the Division of Enforcement is headed in a new direction.

There were likely many considerations that went into how and when to charge Gupta, and in this case, unlike others, we may actually find out what considerations went into the choice of forum. On July 11, Judge Jed Rakoff allowed Gupta's complaint to enjoin the SEC from bringing an administrative order to proceed on the narrow basis of his equal protection claims—that he was treated unfairly because he was sued administratively whereas all the other insider trading defendants in related matters were sued injunctively in district court. Allowing such a collateral attack on an enforcement action is highly unusual, and the outcome is far from certain. But at a certain level what is interesting is not why the SEC chose to bring a cease and desist order against Gupta but why they have not chosen to do this more often.

The SEC first received authority in 1990 to bring cease and desist proceedings under the Securities Enforcement Remedies and Penny Stock Reform Act (Remedies Act). Up until then, the SEC's choices were fairly limited. The agency could sue anyone in district court and they could bring an administrative proceeding against an entity or individual they regulated to bar it from the industry. The problem with such a limited range of sanctions and forums was that by going to federal court, the SEC sometimes was killing a gnat with a sledge hammer—for instance, when individuals did something wrong but the misconduct was more technical or not something worth bothering a federal district court judge about. Under the Remedies Act, the SEC gained much greater flexibility in sanctioning misconduct, including the ability to sue anyone administratively to have them cease from future misconduct. But how to use this new arrow in the quiver was not always easy. Should it be used only for non-fraud cases? Should it only be used in cases where the case law was settled so the administrative process would not be seen as a rubber stamp of the agency? Should it be used in cases against auditors? Lawyers? Could it be used in insider trading cases? One by one these

artificial barriers to using cease and desist actions have fallen, but the SEC has still not used them to the extent they can or should.

Much has been made in the Gupta case (including by the SEC itself) of the SEC using its new powers under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to seek penalties in cease and desist proceedings. The truth is that the SEC could have brought an administrative action against Gupta seeking penalties before Dodd-Frank because he is being charged under provisions that apply to someone associated with a regulated entity—in other words, Goldman Sachs Group Inc., on whose board he sat. Ultimately, Dodd-Frank is not the real issue. Instead, the SEC appears to be engaged in a broad rethinking of how it pursues enforcement actions.

As an aside, much also has been made of the government's use of wiretaps in the recent insider trading cases—and in light of the government's success in the use of these wiretaps it is at a certain level interesting that Gupta is so determined to get his case heard in district court. Clearly we have seen from the trial against Raj Rajaratnam and others that the government has considerable evidence against the current crop of insider traders. The wiretaps are significant in these matters because in previous insider trading cases the government struggled with proving intent. The simple reality, however, is that there are limits, generally resource related, to the government's ability to tape record conversations. And no doubt the U.S. Attorney Offices' resources at some point will be diverted to other uses. This is not to minimize the impact of wiretaps in future white collar cases; they are here to stay, and with the new whistleblower provisions, more enterprising non-government tapers are likely. They just are not likely to have the broad impact as currently feared.

So why is the SEC now more willing to think more expansively about where they bring cases, and why were they unwilling to do this in the past? There are many reasons these proceedings were not utilized more. First, the slowness of the administrative process and perceived issues with the process. The SEC's administrative process has since been reformed and there are fewer issues with the process overall.

Second, the lack of comparability in the sanctions that could be obtained in district court and in administrative proceedings such as with penalties and officer and director bars. It was sometimes the case that a few individuals in a matter must be sued injunctively, and some of the individuals were better suited to a cease and desist proceeding. The entire matter would be brought in district court because there are obvious problems with litigating the same facts in two different forums at the same time. In the Gupta matter, this is less of an issue since most of the litigation in related matters appears to be winding down. In future SEC enforcement actions, cease and desist proceedings will likely be more inviting now that there is little difference between the sanctions the SEC can receive in district court and the administrative process.

Third, more actions were brought in district court because of the lack of discovery in the administrative process. This may seem amazing because in non-emergency actions the SEC is able to investigate a matter prior to filing. However, the staff that litigates an SEC action is often not the same team that investigates and the litigators like to have discovery. In light of the SEC's current resource issues and the relative cheapness of bringing an administrative action this second chance at investigating a matter is likely to become a luxury the SEC cannot afford.

Last, and possibly most importantly, in large part the reticence to bring matters administratively is due to it being ingrained in the psyche of the SEC that an injunction is the gold standard. But the luster of an injunction will start to fade, especially as district courts increasingly question why the SEC is seeking one in light of the agency's enhanced powers in the administrative arena.

All of these factors point in the direction of it being logical for the SEC to pursue more matters administratively. However, without the broad reexamination of the way things are done, the use of cease and desist actions, such as the one against Gupta, and the predictable increased use of cease and desist actions overall, would not have come about. While the proceeding before Judge Rakoff may reveal completely different reasons for the filing of this matter, there is no doubt that the SEC never would have proceeded down this path without a broad rethinking of how and why it brings actions—and this rethinking will lead to more, not fewer, cease and desist proceedings in the future.

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